

29 July 1982

MEMORANDUM FOR: Director of Central Intelligence  
Deputy Director of Central Intelligence

FROM : SA/DCI/IA

SUBJECT : Differing Analyses of Soviet Defense Costs and Soviet  
Dependence on Western Trade

1. Defense had indicated initially that Secretary Weinberger wanted to discuss with you the reasons for differing analyses of Soviet defense spending and assessments of Soviet dependence on Western trade. His interest had been sparked apparently by news reports of the State analysis of East-West trade.

2. The subject was discussed this morning at Secretary Weinberger's breakfast meeting with Secretary Shultz, but Weinberger's staffers report that he has satisfied his curiosity and does not desire to discuss it with you tomorrow.

3. Because I had already asked SOVA to pull together an evaluation of the State analysis and the Census report, I decided to pass them on in to you for your information.

- For background, SOVA explains the reasons for differences between CIA and DIA analyses, which in the final analysis are not significant. This stems from the fact that both agencies use the same data base.
- SOVA critiqued the Census study much the same way that [ ] had done in mid-July. It is a matter of how you want to count the numbers, i.e. calculating percents of GNP or percents of national income and using ruble costs or dollar costs.
- Included for your information is a copy of the preliminary State study, which in fact is a joint State-Treasury paper which has not yet been formally released.
- The bottom line of the SOVA assessment appears to be that, because neither the Census nor the State-Treasury study tries to assess the importance of Western trade on specific segments of the economy, the results of the studies are not very helpful. It is only when you try to assess the

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importance of Western trade on critical segments of the economy do you begin to get an appreciation for the impact of trade embargoes on the Soviet economy.



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**Question:** What are the differences between estimates of Soviet defense costs made by the CIA and DIA?

1. The CIA makes detailed estimates--in constant prices-- of the costs of Soviet defense activities in both dollars and rubles. Ruble estimates are used to assess the burden of defense on the Soviet economy. Dollar estimates are used in comparisons with US resource allocations in a wide range of defense activities.

2. The Defense Intelligence Agency does not make independent detailed estimates of either the ruble or dollar cost of Soviet defense activities. Rather, the CIA estimate, which is created by applying prices to individual Soviet equipment and activities, is viewed as a joint CIA-DIA product since it incorporates all of the relevant information available to either Agency. The basic computer model is run at CIA and the output is shared with DIA. Detailed copies of every ruble and dollar update are passed to DIA. One of DIA's primary functions has been to service requests for the data from the Pentagon and the individual services.

3. The arrangement between DIA and CIA resulted from a formal agreement reached in 1965 by John McCone, then DCI, and Cyrus Vance, then Deputy Secretary of Defense. It was made to avoid needless duplication of effort and to avoid the confusion that would result from two government estimates of Soviet defense costs. As a result, DIA consistently uses the CIA estimates of Soviet defense costs (rubles and dollars) when assessing the trends in and levels of Soviet defense activities in constant prices.

4. While the CIA building block approach to estimating Soviet defense costs is the primary source of the estimates used in both agencies, both CIA and DIA explore and investigate alternative methods. The primary attraction of the other methods is their ability to measure Soviet defense costs in current prices, whereas the building block estimates use a set of constant prices tied to a particular base year. Constant prices are essential in assessing trends in resource allocations over time. Current prices, however, can show certain shifts in the structure of the economy that constant prices will generally understate.

5. These alternative methods, which rely on published Soviet budget and other economic data or statements by Soviet leaders, provide a wide range of very aggregate estimates. Because of the uncertainties associated with these estimates the CIA prefers to rely on the building block approach in its analysis.

6. DIA, on the other hand, has more faith in these alternative results. They were the primary basis for DIA's recent testimony before the Joint Economic Committee. In that testimony, General Williams asserted that the Soviet defense burden measured in 1981 using current prices was 14 to 16 percent of GNP. Our building block estimate for 1980 in constant 1970 prices is 12 to 14 percent of GNP. Because of the absence of cost information we believe it is premature to measure the Soviet defense burden in current 1981 prices. The difference between the CIA constant price estimate and the DIA current price estimate, however, is probably not significant in assessing the general impact of defense on the Soviet economy.

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**Question:** What are the differences between CIA estimates of Soviet dependence on the West and those in two outside recent studies?

1. Two recent studies highlighted in the news give very different impressions of the Soviet Union's susceptibility to Western economic leverage. The numbers cited are too general to show where the key dependencies lie--as in grain, where the Brezhnev livestock program cannot be sustained without imports from the West or in energy, where Soviet requirements cannot be satisfied without Western pipe and equipment. Whether Soviet dependence on East-West trade in certain sectors can be used for leverage--the ability to persuade the Kremlin to change its policies--is highly dependent upon a number of uncertain political factors.

2. We believe that the Bureau of Census study overstates Western leverage.

- o The study's main conclusion is that the share of imports in the Soviet official measure of national income is much higher when the value of imports is adjusted to a domestic price base than when converted using the official exchange rate. The adjusted ratio for total imports rose from about 9 percent in 1970 to about 20 percent in 1980; for machinery alone, imports account for up to 20 percent of all newly installed equipment in 1980.
- o We believe these measures overstate Soviet dependence on the West. Soviet national income does not cover the full range of goods and services included in gross national product as defined in the West. In 1980, imports amounted to about 15 percent of Soviet GNP, roughly 5 percentage points lower than the number calculated in the Census report.
- o Furthermore, the estimates quoted in press reports reflect total Soviet trade, including trade with client states and with LDCs. Hard currency imports were equal to only about 5 percent of Soviet GNP, while they accounted for less than 10 percent of Soviet investment in machinery and equipment.
- o In addition, domestic Soviet prices of many imported consumer goods bear little relation to the domestic resource costs of similar goods. The large excess demand that exists in many consumer markets allows the Soviet pricing authorities to place heavy internal taxes on these goods, which inflate their apparent domestic resource costs.

3. The State Department study finds fairly small impacts on the Soviet economy from cutbacks in Western exports. Our own estimates are significantly larger but still rather small in magnitude.

- o Using the LINK system of econometric models (developed by the Wharton School), State finds that a 50 percent reduction in imports of Western manufactured goods in 1982 and 1983 would reduce the level of Soviet GNP by only 0.2 percent in each of these years. A complete cutoff of such trade would reduce Soviet GNP by 0.4 percent in 1982 and by 0.7 percent in 1983.

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- o One factor that may explain such small impacts is the assumption made about the reduced imports. The State analysis assumes that roughly one-third of the reductions in imports from the West can be treated as consumer goods having no direct effects on the productive capacity of the Soviet economy. In reality, though, the trade classification scheme employed in the LINK model places such crucial imports as steel pipe into this category.
- o Another factor which tends to understate impacts derives from the nature of economic models. The Wharton model (like most macroeconomic models) is based on average relationships which tend to dilute the impacts of changes in the supply of key goods and cannot account for "bottleneck effects."
- o We have looked at effects of Western trade embargoes using our own model of the Soviet economy. We believe these estimates more accurately reflect the various impacts that would flow from a trade cutback, although they also would not fully reflect the costs of bottlenecks other than those associated with energy shortages. Our analysis suggests that the impacts could be as much as double the size indicated in the State study, but the absolute magnitudes would still not be large even with the substantial trade reductions assumed in the state study.

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